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**THE ROLE OF FOREIGN DIRECT INVESTMENT: CASE  
STUDY GEORGIA**

Bachelor's Thesis

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I declare I have written the graduation Thesis independently.

All works and major viewpoints of the other authors, data from other sources of literature and elsewhere used for writing this paper has been referenced.

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## **ABSTRACT**

Bachelor thesis is based Foreign Direct Investment (FDI) it is considered to be one of the potential sources of economic growth for developing countries. Soon after the default of Soviet Union, many former Soviet republics began to open their economies to foreign investments and start to globalize their market. Together with other transition countries, Georgia has also opened its doors to foreign capital in the early years of its independence. In the early years, it was not easy, there were many problems with legislative frameworks, with political instability and undeveloped infrastructure. The objective of this thesis is to review the existing literature on the foreign direct investments, define and analyze the role of foreign direct investments in developing and transition countries, specify the different types and determinants of foreign direct investment, study various policies adopted by Georgia, and finally, give optimal policy recommendations for Georgia.

**Key-words:** Foreign Direct Investment; Economic Growth, investment policy, trade policy, protectionism, economic crises, financial crises, Georgia.

## INTRODUCTION

Foreign direct investment (FDI) are very important for all developing countries, and Georgia is not an exception. Because foreign direct investments play an enormous role in developing economy and countries budget.

One of the obvious examples is China; its experience is unique because the communistically government retained the strict and old political system but at the same time held extensive economic reforms. In the 1990s, China became one of the biggest recipient countries after the USA. Even nowadays China is one of the largest recipients in Asian countries, the number of foreign direct investments is growing every year.

One of the biggest problems of Georgian economy is the attraction and the rational use of foreign investments. The wealth of Georgian economy and its inclusion in world economy depends on the optimal solution of the above-mentioned problem.

The objective of this thesis is to understand what kind of determinant do foreign direct investment have the difference between them. How do those determinants affect different sectors of the economy and its effect on the development of economy?

The thesis subject is the foreign direct investments in Georgia and potential of its attraction. There will be discussed different data of Georgian foreign direct investment. According to on data will be defined strategy and plans. In the second chapter, there will be considered foreign direct investments in former Soviet Union countries as well. There will be declared how do different countries work how do they develop.

The problem of the thesis is to understand what kind of effect foreign direct investment has on Georgian economy. Does the development of Georgia depend on foreign direct investments or it is not important for it? What kind of strategy do Georgian government apply to attract foreign direct investment? What kind of effect does it have?

During the survey, together with the general scientific methods were used: Analysis, deduction methods, system analysis, forecasting, statistical data monitoring and other methods.

During the thesis author used foreign academic studies and research works on foreign direct investment, but used is appropriate for this paper. Mostly has been discussed two types of literature, one type is the determinants of foreign direct investment and second of them is about attraction and different kind of strategies. During the thesis work author has used foreign

authors as well as Georgian ones, used some online sources, the database of the Ministry of the economy and sustainable development, and data of National statistic office of Georgia.

# **1. INVESTMENTS AND ITS PLACE IN ECONOMY**

## **1.1 Investments**

In the system of developing country, investments play a major role in the renewal and increase of productive resources, and, therefore, provide some economic growth. If we imagine social reproduction as a system of production, distribution, exchange and consumption, investments mainly relate to the first link - production, and, one might say, are the material basis of its development.

The very notion of investment (from Lat. Invest - dress) means investing in sectors of the economy within the country and abroad. Distinguish financial (buying securities) and real investment (capital investment in industry, agriculture, construction, education, etc). (Oxford dictionary)

Investment in the real capital is capital investments directly into means of production and consumption of a particular sector of the economy or the company, resulting in the formation of new capital or the increase of available capital (buildings, equipment, goods, inventory, etc.). Real investments lead to reproduction and renewal of fixed capital. It may also be used as loan capital, including bank loan. In this case, the bank is also becoming an investor, provides real investment. In countries with well-developed corporate property virtually all long-term investments are made by way of securities, primarily stocks. Therefore, the real investment is in the main areas of activity of commercial banks.

Apart from the fact that the investment affects the overall efficiency of management and the possibility of long-term growth, they also have a direct and immediate effect on employment and income. If the reduced investment in construction, rising unemployment among construction workers, their total income is reduced, thus reducing their demand for goods and services produced in other industries. This leads to a reduction in revenues and decrease in employment in these sectors. Furthermore, the reduction of investment in construction has a negative impact on those industries that supply materials for the construction itself, for subcontractors for the building materials industry, etc. Investments made by the organization to expand its production facilities are a stimulus for the economy.

## 1.2 Determinants of foreign direct investment

FDI (foreign direct investment) historically refers to a moment when a company builds an asset abroad. Now a day the definition of FDI has enlarged and included three components: 1) the foreign company buys a domestic firm 2) when a foreign company builds a joint venture with a domestic firm; 3) when both foreign and domestic companies agree to create an alliance in the local market. (FT Lexicon)

Portfolio investment is indirect from investment and differs from these types. So-called passive ownership of an asset occurs, so in a later point, the foreign company does not interfere in the management presses. In this thesis work focuses on the direct type of investment.

Chrysochoidis, Millar and Clegg (1997) in their book have talked about the main motivation points of the firm to invest. So why do they invest? The first reason is if in the inviting country is missing any production. Secondly, the list of reasons is occurring these are cheap labor force, grants, subsidies or tax allowances. The third case company tries to reach foreign consumers in order to increase sales. The last type of investment refers to a situation in which tariffs or other trade barriers restrict the products of a foreign firm from entering the domestic market. The fourth case of investment is a result of competition between local and foreign enterprises, creating ventures to have an advantage on an international level against the third party

According to Al-Sadig (2013) the share of world outward foreign direct investment has increased between 1980 to 2011 from 6.2% to 26.9% and peaked in 2010 at 31.8%. According to him foreign direct investment in business or production from another country, and it is a significant especially for countries with transition economies. (Al-Sadig 2013)

The results of the empirical study demonstrate that the economic factors of the foreign direct investments usually are contradictory. Most cases the differences emerging depends on the type of investment whether it is market or resource seeking nature. In market seeking mostly investors build the production process on the territory of the beneficiary country to serve the host market, the cause of large market size or high income. In the second case of resource-seeking, the investor builds its production on the territory of the host country in the case to export its production abroad. The reasons of this type of FDI could be the availability of natural resources, low labor costs or convenient legislative framework.



Market size is an example of how duplication can lead to different conclusions. The importance of Market size to attract the FDI again depends on whether is “market seeking” or “non-market/resource seeking”. The main characteristic of FDI in most cases is the host countries large market size. As Charkrabarti (2001), mentions in his work to benefit from the economies of scale there should be a huge market, but at first, it should reach to the certain level of development, this way the flow of FDI will start to increase and the market will continue the way of development. According to the several studies, it looks like FDI will go to the markets that have enough value and has high purchase power. (Artige and Nicolini (2005). Market capability does not have a great importance for resource-seeking foreign direct investment.

Some authors argue that high growth rates promote FDI inflow in the country. Among them are Schneider and Frey (1985). Others find mixed evidence for growth, for examples: Nigh (1985) finds no positive relationship between growth and FDI in the case of developing countries while in the case of developed countries he finds a weak negative correlation.

The role of low labor costs is not a huge subject of debates in the literature. There is no clarity in the studies whether foreign direct investment is attracted by wage rate. According to Goldsbrough (1979), and Flamm`s (1984) studies labor costs are usually measured by the wage rate, and most studies show that there is the strong negative consequence between the foreign direct investments and the wage rate. A perfect example will be low wages implies high FDI.

Studies of Asiedu (2002) in African countries did not show the same result as would be in developed countries. According to her studies, it is clear that the factors affecting the foreign direct investment in developed countries do not have the same consequences in Africa. Her works show that foreign direct investment has different determinants among which are: political instability. Legislative frameworks, market size and labor costs.

As for the methodology and data, Asiedu begins her analysis by determining the variables that were relevant in explaining the variation in FDI/GDP for her sample. She used ordinary least square for all the estimations. The results can be seen in Table 1. in the table the columns 1-4 are results of cross-section regressions, where the variables are averaged over the ten years period, 1988-97. Column 5 reports results for a panel regression. The variables are averaged over tree periods: 1988-1990, 1991-93 and 1994-97.

**Table 1** Ordinary least square essential

Variable	(1)	(2)	(3)	(4)	(5)
Intercept	4.32 (0.146) <sup>a</sup>	6.188*** (0.000)	6.523** (0.047)	13.098** (0.013)	12.252*** (0.002)
<i>OPEN</i> = 100 * (Imports + Exports)/GDP	0.030*** (0.000)	0.032*** (0.000)	0.032*** (0.000)	0.033*** (0.000)	0.035*** (0.000)
<i>INFRAC</i> = log(Phones per 1,000 population)	0.837*** (0.002)	0.574** (0.032)	0.623** (0.052)	1.399*** (0.001)	1.345*** (0.000)
<i>RETURN</i> = log[1/GDP per capita]	0.906* (0.056)	0.997** (0.026)	1.112** (0.032)	2.220*** (0.007)	2.107*** (0.007)
Africa dummy		-1.342*** (0.002)	-1.415*** (0.001)	-1.451*** (0.001)	-1.523*** (0.000)
GDP growth			0.004 (0.966)		
100 * Government consumption/GDP			0.027 (0.562)		
Inflation rate			0.000 (0.629)		
100 * M2/GDP			0.002 (0.862)		
Political instability			-0.022 (0.972)		
<i>OPEN</i> * <i>AFRICA</i>				-0.005 (0.615)	-0.003 (0.742)
<i>INFRAC</i> * <i>AFRICA</i>				-1.374** (0.014)	1.384*** (0.001)
<i>RETURN</i> * <i>AFRICA</i>				-1.800* (0.059)	-1.611** (0.027)
Adjusted R <sup>2</sup>	0.6043	0.6530	0.6244	0.7119	0.5706
Number of observations	71	71	68	71	211

**Source:** Elisabeth Aseidu (2002)

The dependent variable in Asiedu's regressions is the ratio of net FDI flows to GDP. The independent variables included in the analysis are a return on the investment in the host country, infrastructure development, the openness of the host country and political risk. The author also tests other economic variables that may determine the FDI: "government consumption to GDP as a measure of the size of government," "inflation rate as a measure of overall economic stability." and "growth rate of GDP as a measure of the attractiveness of the economy." The result regarding the latter proposed variables is that low inflation, limited government spending and high economic growth probably promote FDI inflows.

Below is presented a short general description of the variables tested by Asiedu:

(a) Return on the investment in the host country: usually, a country with an offer of higher return on assets will get the higher share of foreign direct investments. Because of lack of statistics among the African countries, Aseidu assumed that the return on capital is equal to

a marginal product on capital. In other words, countries with high GDP PPP will have low rates on capital.

(b) Infrastructure development. Asiedu means that increase of productivity depends on a good infrastructure, thus high productivity encourages foreign direct investments. Usually undeveloped infrastructure can have a positive impact on investments as well negative one. On one hand the lack of infrastructure in a country could be a motivator for an investor to invest in the sector, when at the same time destroyed infrastructure can be scare for an investor.

(c) The openness of the host country. Asiedu refers to “the ratio of trade, to GDP.” The effect of openness depends on whether FDI is “market-seeking” or “non-market seeking.” In one case when an investor wants to invest in the country and serve the host country with its service and production the countries restrictions of trade and import can have a positive impact. In this case, the investor will have no competitors and can develop its production. In another instance in resource-seeking type investments when an investor in low labor, for example, can face significant problems if a country has restricted export or as trade barriers.

(d) Political risk. Political risk is one of the determinants Asiedu tested in her case study. To measure political instability she estimated an average number of assassinations and revolutions. Her studies show that the political instability has the impact on foreign direct investments. The same author will discuss below in an example of Georgia.

To summarize Asiedu`s study we can say that good infrastructure, openness and high return on capital could be the major factors that increase the foreign direct investments inflow in the developing country. She assumes that most foreign direct investments in developing and African countries are based on resources, labor, and infrastructure.

To discuss deeply Asiedu points on the three distinctions between African countries and other surveillance countries: The first “Higher return on capital promotes foreign direct investments to non-African countries, but has no significant impact on foreign direct investments flows to African countries, *ceteris paribus*.” According to her reasons could be the high-risk environment. The second “Openness to trade promotes foreign direct investments to both African and non-African countries. However, the marginal benefit from increased openness is less for African.” Asiedu mentioned that when an investor decides where to invest in the country or not the thinks about the policies that are designed to open trade and assess their credibility. According to Asiedu Countries, trading policies don`t have to be financial tools for economic balance, and lots of trade reforms also scare the investors. In many cases reforms

of trade liberalization often are limited. The third “Infrastructure development promotes FDI to non-African countries, but has no significant impact of foreign direct investments flows to African countries, *ceteris paribus*.” This situation is similar in cases when the investments are based on natural resources.

According to Asiedu`s research, we can analyze the foreign direct investment inflow in Georgia as the study results show 60% of foreign direct investments are attracted by following determinants: open economy, high capital return, and good infrastructure. During the early years of independence as well as in African countries investments were mostly in base resource nature. At that time infrastructure in Georgia was not developed at all. Moreover, it was destroyed but it did not change the amount of foreign direct investments in Georgia.

Some authors argue for the connection of human capital as a huge determinant of foreign direct investments inflow. Across developing countries the tests of the role of human capital have shown the strong evidence of this factor. They argue that there were a couple of difference views between investors in a different period. Starting from the 1950s, 1960s and 1980-2000 the tendency of investments in various sectors have been changed. In the 1950s, the biggest investments were concentrated in countries with rich “resource market”. In 1960s foreign direct investments were main directed into the manufacturing sector. Host country market size and demand became principal motivation for foreign direct investments. In the early 1980-2000s, the main investments sector became service and technology-intensive sector.

Through their studies evidence shows that the role of natural resources in the attraction of foreign direct investments has lost their importance. Moreover, the low-cost labor as determinant has been replaced by the skills, capital, and knowledge. So the educated workers and proper equipment have become primary determinants of foreign direct investments in developing countries. (Noorbakhsh, Farhad, et.al. 2001)

According to other authors foreign direct investments mostly depend on economic and political determinants of the country. In a country where there is a political instability or in which there is a threat of having the investment nationalized is more of a risk and, therefore, is less attractive, on the other side the country that offers political stability, adequate compensations and guarantee in property are attractive for FDI. This is clear as we have an example of Georgia we can clearly see that the unstable situation of 2008 after the war with Russia the FDI has significantly reduced. The numbers are tremendous since the war in 2008 FDI has reduced by 41% in 2009. (F Schneider, B S. Frey 1985) Also, we can use the study of

Basi (1963), and Aharoni (1966) who has several survey studies found that political instability is the most important variable influencing the foreign investment decisions, aside from market potential.

The author of the thesis concludes that there are many different determinant that attract foreign direct investment, there are many conditions when country either increases investments or investments are decreases. Depending on the different country the economy and strategy are different. The countries that are on a starting level of development their foreign direct investment in most cases are resource seeking because for foreign companies it is important to have low labor cost and liberal tax legislation, precisely such situation is in countries with developing or transition economies. The geographical location is also important in the attraction of foreign direct investment this is also a big determinant.

### **1.3. The impact of foreign direct investment in economic growth and social and economic development**

Today`s processes of globalization in the world economy have a significant impact on the economic growth of individual countries. A significant increase of globalization is manifested in the fact that foreign capital has become an important component of any economy.

According to Bosworth and Collins (1999) studies international capital flows are carried on different levels of the economy, as well as have various forms of capital. These forms are international loans, foreign direct investment, and foreign portfolio investment. However, it seems, foreign direct investments are the best way of raising capital. (Bosworth and Collins (1999) The purpose of this chapter is to demonstrate the role in the processes of economic growth and social and economic development, foreign direct investment play.

Capital in the form of foreign direct investment is considered to be the safest and most useful form of investments into the country from abroad. Primarily, this is due to the stability in the long term, as well as the low sensitivity of this form of investment to short-term changes in economic conditions in the financial markets. (Theodore H. Moran 1999)

In the most economic literature, there are a lot of different definitions of foreign direct investments. However, despite the use of multiple definitions should be noted that most of them contain similar wording to indicate that foreign direct investment is an international movement of capital, which have long-term nature, are associated with the movement of funds, expertise, and technology, as well as everything related to the impact on the activities of companies and their management. The most often cited and used the following definitions:

According to Organization for Economic Co-operation and Development, foreign direct investment is defined as projects (investments), which leads to long-term effects of a resident of one country to a company in another country. The consequence of this is a long relationship between the investor and the enterprise recipient of foreign direct investment, manifested in the effect on the operations and management of the company. The investments required to be referred to foreign direct investment should not be below the threshold of 10% of the share capital of the enterprise. (OECD)

In some works on the economic theory of the foreign direct investment are received as equity investments carried out by a foreign investor in another country with the intention of obtaining a direct impact on the company's business, takes the form of financial resources, human capital, technology, know-how, etc. According to Baratashvili E. and Bulia L (Tbilisi 2011), it should emphasize once again that foreign direct investments are made in order to implement long-term control over the enterprise. According to some authors, foreign direct investments by foreign portfolio investments have a different impact on control and long-term impact on the company. Portfolio investment applies only to the purchase of shares of the business, rather than to manage it. It has to be emphasized that regarding economy foreign direct investment is similar to domestic investment; both have differing origins.

Their work shows that the essence of foreign direct investment in their use to refill the shortage of capital in the internal market. The ultimate goal is to provide resources and skills that will enable the company to maintain and strengthen its market position by optimizing and improving the organizational structure. Besides, these investments contribute to the technological modernization of the economy and the dissemination of new management methods. It should also be noted that as a result of the inflow of foreign investments has an

effect of reducing unemployment and stimulates demand in the labor market. (Baratashvili E. and Bulia L 2011)

Companies operating in the international arena, before taking a decision on the placement of finances abroad take into account many factors (economic conditions). These conditions are often referred to as the investment climate of the host country. It is similar in importance to the region's natural resources, to influence the choice of the region for foreign direct investment. Among the most important factors for foreign direct investment are:

- The economic climate (infrastructure and economic development, the expected long-term changes in economic conditions, while foreign investors recognize the satisfactory growth in the range of 3-5%);
- The social climate (the situation in the labor market, etc.);
- Political environment (political stability, public support for foreign investors, government policy concerning foreign investment, the level of corruption). (Aseidu 2001)

It should be noted that many countries are trying to attract foreign investors, as their savings for developing their country goals. They believe that foreign investors will significant influence on companies with no organized management and will fill the governmental plan with their capital. Those companies will have an opportunity competing with new foreign companies and will develop by themselves.

Foreign direct investment can take many different forms of participation (full or partial) in the enterprise, as well as can be implemented in the form of a new company. The impact on foreign direct investment balance of payments can be traced through a list of all business transactions carried out by the society of the host country to the outside world. The following can be seen:

- The current account;

- Financial accounts (portfolio investments, direct investments and other investments such as foreign loans, loans, cash in current accounts) and capital (capital transfers from the value of investment assets received free, donations for the purchase of fixed assets and the disposal of non-produced assets unfunded including purchase and sale of copyrights, patents);
- The balance of foreign exchange reserves.

The inflow of foreign direct investments plays a significant role in the host country in the formation of the exchange rate policy, in particular, the interest rate policy. In the fact, on the one hand, raising interest rates attracts the foreign investment, and on the other there is a negative impact on domestic investment processes.

Foreign direct investment, on the one hand, can have a positive effect on improving the balance of payments of the country (due to foreign capital inflows, the external balance of the economy, improved terms of trade, import substitution). However, these investments may also have an adverse impact on the balance sheet of the host country as a result of the elimination of domestic investments, an increase of import and the outflow of profits earned in investor's country.

Author thinks that today's global economy, as mentioned above, is characterized by influence processes of globalization. The most important determinants of this process are the participation of countries in international capital flows and participate in the development of new technologies. It should be noted that among these elements are closely linked, as there is no possibility of the development of technologies without capital inflows.

Technology transfer in foreign direct investment is complex. Often used the so-called package technologies. The main components of this package include human capital, physical capital and intangible assets, as well as various forms of cooperation. The most important consequences of the impact of foreign direct investments on technological progress includes:

A new model of management and organization;

- Impact on employment, skills development and education;



- New technologies used by foreign companies;
- Modern production (production of high-tech products, improved product quality and a high volume of sales);
- The use of environmentally friendly technologies and solutions to improve the safety of the environment

Foreign direct investment, as already indicated, it is not only the flows of financial capital but also the transmission of knowledge and management skills from developed countries to developing countries. The concrete result of this kind of positive effect is the reduction or even total elimination of the digital collapse, people especially new generation has an opportunity to get right knowledge.

The primary source of competitiveness is technology, skills, and improve responsiveness to innovation. With the influx of new technology, innovation and business processes increase the efficiency of both domestic and foreign companies. The consequence may be an improvement of the economic situation. It should be emphasized that the benefits of foreign direct investments depend on technological resources as well. It is worth noting that the development of the research activities of companies (corporations) can have a positive impact on the international development research activities of foreign investors in the host country.

In general, it can assume that foreign direct investment plays a significant role in improving the technological progress in the host country.

Foreign direct investments have impacts on the labor market as well. The most important of these are:

- Mergers and acquisitions related to the change in ownership, which is the result of maintaining the current level of employment, or even job cuts. The rationalization of employment;

- New branches in the capital of the host country, which is directly connected with the creation of new jobs;

- Actions (strategy) of foreign companies can be carried out in the transfer of production abroad. Replacing domestic production can reduce employment. However, if overseas production is in addition to domestic production - it contributes to the removal of financial, technological and institutional "bottlenecks". In this case, there is a beneficial effect on the operation of enterprises;

- The economic policy of the host country of foreign investment should be focused on the positive impact of the foreign direct investment.

Foreign direct investment has a positive impact on employment, particularly in countries with high unemployment. The influx of foreign investment leads to higher productivity, and often an increase in wages. Very often these two effects occur simultaneously (the creation of new jobs or the replacement of existing, higher-paying optional)

By author's opinion in many cases, salaries at foreign enterprises are higher than in national companies. Higher wages stimulates the growth of labor productivity. The increase in wages in foreign companies has a positive effect on the growth of wages in the economy as a whole.

The analysis in the work confirms that foreign direct investment contributes to the sustainable economic growth and social and economic development. Foreign direct investment provides modernization of production facilities, improve the quality of growth and attract new investment. The impact of foreign investment on the host economy is ambiguous and multifaceted. It should be noted that the benefits for the host country depend on many factors, including the social, economic and political situation in the country.

Foreign companies can significantly affect the performance of domestic firms. This is because the national players are forced to take appropriate steps to catch up with foreign competitors. The result is technological progress, increased knowledge and improved

management procedures in all enterprises, including national companies. Foreign direct investment also contributes to employment growth in the domestic market.

There is particular unclear position in the literature about the relation of economic growth and foreign direct investments. Some studies show that high growth rates promote FDI inflow in the country. Among them: Lunn (1980), Schneider and Frey (1985), Culem (1988) and Gastanaga (1998). Others contribute mixed evidence for growth, for examples: Nigh (1985) finds the weak positive relationship between growth and FDI in the case of developing countries while in the case of developed countries he finds the weak negative correlation.

The labor costs role in literature is less subject for debate. The wage rate mostly calculates the labor costs, and most studies concern the high adverse effect between FDI inflow and wage rate. To be certain, high wage implies low foreign direct investment income. (Ceglowski, L & Golub, S 2007)

## **1.4 Attraction of foreign direct investment**

Foreign direct investment (FDI), considered as the most important for countries with transition economies. Compensating for a shortage of domestic savings, these investments by their very nature involve the creation of new enterprises, a fundamental restructuring, and expensing existing businesses and thus contribute the most growth of the economy.

Measures aimed at creating an attractive environment for FDI includes three main groups:

- basic measures to create a favorable investment climate;
- legal and administrative framework for foreign investors;
- Specific incentives for FDI.

Unlike most countries in Central and Eastern Europe, the Commonwealth of Independent States (CIS-former soviet union countries) countries have not been able to solve the problem is to create a favorable investment climate, provides for a stable political and

macroeconomic conditions, protection of property rights. However, improving the investment climate in itself is not capable of producing a sharp increase in foreign investment. As the experience of countries with developing and transition economies, improving the investment climate is a necessary but not sufficient condition for FDI. This requires the implementation of measures to create the legal framework for foreign investors and specific incentives for FDI aimed at improving countries' investment attractiveness for foreign investors and attract their attention to promising investment projects in the country. (Baratashvili E. Bulia L. 2011)

The effectiveness of the formation of the legal framework for foreign investors depends crucially on the extent to which the country has managed to implement basic measures to create a favorable investment climate. As a result, the same set of regulatory mechanisms and guarantees may differently affect the investment attractiveness of countries differ regarding stability of the investment climate and its conformity with the interests of foreign investors. Countries with developing and transition economies, in most cases, provide additional guarantees to foreign investors and economic activity, often as necessary incentive exemptions from national treatment.

In modern conditions the most important kinds of specific incentives for foreign investors are the following:

- Fiscal incentives: tax holidays, exemptions for income tax, benefits in respect of funds used for investment and reinvestment, accelerated amortization regime, income tax exemptions for foreign employees of enterprises with foreign participation, benefits in carrying out activities related to research and development, advantages in the implementation of international trade operations, and others;
- Financial incentives: payment of government subsidies to cover part of the costs of starting capital, providing preferential loans or loan guarantees, providing favorable conditions for public security, public equity participation;
- Other incentives - public expenditure on the establishment of investment infrastructure, the creation of zones with individual economic status, and others. (Baratashvili E. Bulia L. 2011)

Despite a rather critical attitude of international organizations to the use of such incentives, they are actively used by most countries of the world in the competition for attracting foreign direct investments. Moreover, the use of incentives in the world has increased

significantly. In these countries with market economy in their practice mostly relies on financial incentives and investment in infrastructure, and developing countries and countries with transition economies - on fiscal measures. The strategic objective of policies attracting FDI should be providing national treatments for foreign investors, providing favorable conditions for FDI in the economy. (Baratashvili E. Bulia L. 2011)

This requires a serious preparatory work on changing tax, investment, and corporate law, which could lead to an intensification of the investment process. The existing the national regime of economic activity in Georgia is attractive to foreign companies. Given the increased competition in the world for foreign investment, accompanied by numerous countries providing incentives to foreign investors, and most important - the unfavorable investment climate in the CIS countries, the principle of national treatment should be supplemented by a system of privileges and guarantees for foreign investors. (Baratashvili E. Bulia L. 2011)

Along with the application of the principle of national treatment is also required implementation of certain internationally accepted principles of the legal regulation of foreign investment. Treatment of FDI should be characterized by high transparency.

The principle of transparency means that the legal rules governing the activities of foreign investors should be open and to avoid ambiguous interpretation and review procedures for these standards should be public and take place under conditions that allow for interested parties (including foreign companies) the opportunity to express their position on the issues discussed issues. Policies towards FDI must include the following essential characteristics:

- a clear, coherent strategy that reflects the seriousness and longevity of the intentions of the state in attracting FDI, causing investor confidence;
- the consistency of the main provisions of the policy attracting FDI in all branches of government at the regional and federal level, as well as in business circles;
- Conformity declarations and real actions, the lack of short-term political changes, a clear, concrete program of action of the federal government and regional level, ensuring the improvement of the investment climate.

Policy priorities attracting FDI in the CIS countries should focus on several aspects:

- the promotion of individual, necessary for the economic activities, including the export of competitive products and the import of new technologies;

- sectoral priorities: attracting FDI in high-tech industries, industries that have the character of "bottlenecks" in the economy and industry that contribute to the development of exports - oil, gas industry, power engineering, metallurgy;
- priorities for companies: Currently, it is impractical to stimulate investments of large enterprises, but at the same time it is necessary to pay attention to the attraction of investments in small and medium-sized foreign companies that need improvements of the overall legal framework to promote FDI and providing guarantees of stable conditions of investment activity at the federal level;
- Priorities for Regional Development: instead of creating artificial practices favorable conditions for investment activity in individual subjects by granting them the status of free economic zones is necessary to use a new strategy to use the resource potential of the regions with the development of infrastructure and the administrative institutions necessary for a target to attract prospective investors;
- Country priorities: advancing the process of attracting FDI in the country's economy needs to diversify sources of investment flows both by the developed countries and countries with rapidly growing markets. (Abralava A. 2011)

This will require:

- - increase spending on research and development of the state budget, which would allow increasing the number of research and development on the problems of reducing the cost of production and sales of products;
- - impose strict restrictions on the export of currency.

According to many analysts, to the reasons for the decline in investment activity in Georgia are:

- - the high cost of commercial loans; the percentage is ten times greater than in Europe. (NBG 2015)
- - Insufficient financing of investments from the budget and other financial sources; after 2012th government changes deep financial crises has begun in Georgia, 2014 years final report of the minister of finances of Georgia Mr. Nodar Khaduri has stated the state budget gap. (economist.get 2015/01)
- - lack of effective mechanisms of transformation of savings into investments;
- - A high level of financial (including investment) risks because of weak legal protection of domestic and foreign investors. The level of risks is high after the year 2008 when Russian

army has intervened in the war between Georgia and South Ossetia. (interpressnews.ge 2009)  
(Abralava A. 2011)

In author's opinion there are many ways to attract the foreign direct investments, in case of Georgia it is clear that the country is on developing stage but they are working in a proper way to attract the investments. The change of reforms of legislative framework, the tax holiday and the reforms to lower the corruption this all helps it to improve in a right direction. There are some factors that scares investors but pros are so much more that the country is still getting the investment.

## 2. CASE STUDY GEORGIA

### 2.1 Foreign direct investment analysis in former Soviet Union countries

Foreign direct investment has a tremendous role in supporting the economic growth in former Soviet Union countries. It is filling the gap between needed investment and domestic savings. In a medium term for post-Soviet Union countries, it is improving the position of the country on an international market.

Since the Soviet Union collapse the investment from foreign countries have declined dramatically, the break up has destroyed the country's economy that was held on the Commonwealth. In comparison with Central and Eastern Europe, the foreign direct investment net inflow per capita has remained still low.

According to Charkrabarti (2001), there are two motivators of foreign direct investment resource seeking and market seeking. Moreover, foreign direct investment inflow biggest motivator in former Soviet Union countries according to Lankes (1996) is resource-seeking as there is low labor cost the foreign direct investment are more focused on export. But countries with the big population and huge markets such as Russian Federation and Ukraine can be market-seeking as well. The potential of selling product in large population country is enormous.

**Table 2** FDI Net inflow per capita USD (current US dollar)

N	Country	FDI in US\$	Population	FDI per capita
1	Luxembourg	30,075,373,593	543,202	55366.8
2	Netherlands	32,109,654,413	16,804,224	1910.8
3	Austria	13,843,770,472	8,473,786	1633.7
4	Spain	44,917,006,387	46,647,421	962.9
5	Estonia	964,588,953	1,324,612	728.2
6	Germany	51,266,993,711	80,621,788	635.9
7	Norway	2,627,258,488	5,084,190	516.8
10	Russia	70,653,718,709	143,499,861	492.4
11	Latvia	880,800,000	2,013,385	437.5
12	Azerbaijan	2,619,437,000	9,416,598	278.2
13	Lithuania	712,435,949	2,956,121	241.0
14	Belarus	2,246,100,000	9,466,900	237.3
15	Italy	13,126,395,561	59,831,093	219.4
16	Georgia	949,335,750	4,476,900	212.1



17	Armenia	370,196,773	2,976,566	124.4
18	Ukraine	4,509,000,000	45,489,600	99.1
19	France	6,480,400,817	66,028,467	98.1
20	Moldova	249,040,000	3,559,000	70.0

**Source:** World Bank (2014)

In Table 2 there are data from the database of World Bank (2014), in the first row of the table are listed the countries from former Soviet Union countries, Central and Eastern Europe, in the second row there are foreign direct investment inflow in this countries (US\$), in the third row there is listed the country population and in the last row there is foreign direct investment per capita. As mentioned above, we can see that top seven countries with the highest income of foreign direct investment per capita are from Europe only eighth country is from the former Soviet Union. It is not surprising because the market of Russian Federation is big and attraction of foreign direct investment is high.

**Table 3** Primary income on foreign direct investment, payments (current US dollar)

Country	2011	2012	2013	2014
Armenia	378586265.5	334890199	324006673	169262811.6
Azerbaijan	5488366000	4906186000	4507227000	3359274000
Belarus	118570000	1257600000	2373400000	202000000
Georgia	800215342	747230586	769656129	688133696
Kazakhstan	25213230739	24739809593	22722195647	0
Moldova	256710000	117020000	164840000	162340000
Tajikistan	7159600	33935900	24100000	41826649
russia				70653718709

**Source:** Data World Bank

Table 3 shows the primary income on the foreign direct investment. According to data from World Bank can be observed that top post-Soviet Union countries are Azerbaijan, Russia, Kazakhstan and Georgia. Azerbaijan and Kazakhstan are countries with big with the huge territory and natural resources: oil and gas. Russia with a big market and low labor cost are attractive for foreign companies. The last small country that is leading among former Soviet Union countries is Georgia. There is not a big market the infrastructure is on the stage of development; the politic is not stable, but the country is attracting investments. The author thinks that the reason is the geographical location, on one hand the neighborhood with Russia territorial problems are not good but on the other hand, the place between Europe and Asia helps to be a transporting country. The new reforms to lower the corruption and clear strategy to Europe is making Georgia an attractive country.

**Table 4** Foreign direct investment, net inflows (% of GDP)

<b>Country</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>
Armenia	6.4	4.7	3.4	3.5
Azerbaijan	6.8	7.7	3.6	5.9
Belarus	6.7	2.3	3.1	2.4
Georgia	6.0	2.7	4.4	10
Kazakhstan	7.3	6.7	4.3	3.5
Moldova	5.0	3.9	3.6	4.4
Tajikistan	1.0	2.6	-0.6	2.8

**Source:** Data World Bank

Table 4 shows the foreign direct investment net inflow % of GDP. By this data is leading Georgia 10% of GDP is foreign direct investment. This means that foreign direct investment has a big importance for Georgia.

## **2.2. Analysis of foreign direct investment in Georgia**

By last decade, Georgia was the world's most successful post-Soviet Union countries in attracting foreign direct investment. This thesis examines the extent of this process and its effects on the Georgian economy. The author will try to provide an overview of Georgian FDI since the early 2000s, identify the factors that led to FDI inflows, and describe the effects of FDI regarding output, employment, trade, and R&D expenditures, among other variables.

One of the fundamental changes associated with the restructuring of the Georgian economy in the past nine years, is the radical formation of the financial sector, the active development of financial markets and the establishment of relevant institutions. Investment remains the acutest problem of the essential conditions for determining the course of reforms. The global nature of the problem of investment is the need to create a tool for analyzing and forecasting the situation in this area.

In the second part of the thesis, the author will analyze the inflow of foreign direct investments into Georgian economy. Great importance for Georgia is the foreign investment because a lot of people during the development of economic market "knocked up" his great wealth, which currently lies in European and American banks, in other words, are used to invest

in foreign countries. During this period, the cumulative GDP is estimated to have been more than 70% between 1990 and 1994, and by the end of 1996, Georgian economy had shrunk to around one-third of its size in 1989. The state is trying to get this money back from abroad in the Georgian economy, which will give a tangible boost to the Georgian production. According to the law enforcement agencies of Georgia since 1991, about 3 billion Dollars was moved from Georgia to foreign countries, and it is not difficult to imagine how the money would manifest itself in the Georgian economy. (The National Statistics Office of Georgia 1990-1996)

In Georgia there are a couple of commercial organizations with sufficient amounts of investment in real projects, however, the instability of today's understanding of the Georgian market, they agree to fund a project very carefully, mindful of the fact that a sufficiently high probability of bankruptcy yesterday and most reliable established companies. There are a lot of Georgian businesspeople in Europe and Russia having big capital, but they are scared to invest in Georgia big capital because of uncertain political and economic condition of the country.

Georgian potential investors for a long time do not trust the government; this distrust is primarily due to prevailing stereotype attitudes to power the Georgians - "the government is working only for themselves." However, public investment policy now is directed to ensure that provide investors with all the necessary conditions for the Georgian market, and because in the future we can expect a change in the situation in the Georgian economy for the better. The Georgian market - one of the most attractive for foreign investors, but it is also one of the most unpredictable, and foreign investors are rushing around from side to side, trying not to miss a piece of the Georgian market and, at the same time, do not lose your money. At the same time, investors are afraid of the conflict with Russia, at the moment it is frozen and everything is stable, but no one knows when it will "wake up again," this makes one of the fastest developing economy and market, one of the riskiest one.

All investments held by investors primarily for profit, and as long as it is dealing with an unbalanced economy, uncertain political situation and imperfect legislation, neither of which profit is not out of the question, and therefore there can be no question of a long-term strategic investment in Georgian economy, without which, in turn, cannot lift production, is the revival of the Georgian economy.

This thesis is to assess the prospects of the Foreign Direct Investment climate in Georgia and its activation by current trends of development activities of investors and investment policy of the state in which it is necessary to identify the most weaknesses and indicate the necessary

steps to address them. By the stats we can analyze how do the investments affect the economy, how do they change, while changes in political or economic instability or crisis. According to definition of international organizations such as the International Monetary Fund (IMF), The Organizations for Economic Corporation and development (OECD), and the United Nations Conference on Trade and Development (UNCTAD, FDI can be described as the long-term financial participation by an investor from one particular country in an enterprise to another country, thereby having a significant degree of influence on management of the company.

A precondition for stable economic growth is foreign direct investments. It has particular importance in Georgia, as it is a developing country.

According to the World Bank report "Investing Across Borders 2010", Georgia is one of the most open countries to foreign investment, among 87 countries. A World Bank study "Investing Across Borders 2010" have analyzed the foreign direct investment in 87 countries. The indicators focus was on four thematic areas, namely, the ability of foreign companies to invest in this or that country, to industrial land, ownership, and business-related disputes.

World Bank studies have shown that by all indicators Georgia is open to foreign capital, and there are no restrictions on foreign companies. Four days is enough to start a business in Georgia, while in Poland it is necessary to do in 33 days, in Russia - 31 days, in Greece - 22 days, Bulgaria - 20 days, in Armenia - 18 days, Turkey - 8 days. To start the business it takes more than six months in Angola (263 days) and 212 days in Haiti. It should be noted that the Georgian case was the best among all the countries. (World Bank 2010)

In 2008, the law of the land ownership registration was simplified, and registration dates have been shortening. It is possible to rent the land as well as to buy it, and there is no restriction regarding the land area. Renting land in Georgia takes 1 week, even in Poland, for example, such a procedure needs five months or more. Renting the state-owned lands in Georgia takes about 50 days while in Bulgaria it takes almost one year (351 days). Among the tested countries by the freedom of economy, Georgia is on 26th place. According to the studies improvement of investment climate in the country is not possible without legislation. (Ministry of Justice of Georgia)

A stable investment environment in Georgia is a prerequisite for direct and portfolio investments. Investment legislation of Georgia is improving and is oriented to make investment climate of Georgia more attractive. (Ministry of Justice of Georgia)

According to the ministry of justice after war 2008 between Georgia and Russia, big legislative reforms have been started. The government began to support investments to reanimate Georgian economy after the war. The „government is supporting the investments“law was enacted. This law was aimed to support the Capital investment and business activities with the improvement of procedures and additional legal regimes. It is applied to any foreign and local investment, invested on Georgian territory. The National investment agency was created in 2008 which became the representative of the state in dealing with investors. The activities of the agency are controlled by the Ministry of Economy. Agency provides services to all investor and helps them with all necessary licenses, permits, or other representative authorizations. This service is not free (with the exception of particular importance to the investment), and the service fee is determined by the Ministry of Economic development of Georgia. (the Ministry of Economic development of Georgia)

The recent period shows that foreign direct investment has been increasing largely, this can be assumed to the fact that Georgia looks to be attractive to foreign investors. Despite year 2009th unstable political situation in the country and decrees of foreign investment, Georgia is still the leading country by attracting foreign capital among Soviet Union countries and in the region. On average, the foreign direct investment amounts 10.57% of GDP. But it is important to emphasize that mitigation of political risks in Georgia is a problem for foreign direct investments. (National Statistics Office of Georgia)

**Table.5** Foreign direct investment in Georgia

Mln. USD				
year	Tot	I qv.	II qv.	III qv.
1996	<b>3.8</b>	...	...	...
1997	<b>242.6</b>	...	...	...
1998	<b>265.3</b>	...	...	...
1999	<b>82.2</b>	...	...	...
2000	<b>131.2</b>	...	...	...
2001	<b>109.8</b>	...	...	...
2002	<b>167.4</b>	...	...	...
2003	<b>340.1</b>	...	...	...
2004	<b>499.1</b>	...	...	...
2005	<b>449.8</b>	89.4	105.9	75.6
2006	<b>1,190.4</b>	146.0	306.9	280.7
2007	<b>2,014.8</b>	421.4	401.5	489.1
2008	<b>1,564.0</b>	537.7	605.4	134.7
2009	<b>658.4</b>	114.0	177.2	173.2
2010	<b>814.5</b>	166.5	208.3	225.6
2011	<b>1,117.2</b>	209.7	248.3	316.6

2012	<b>911.6</b>	261.2	217.7	199.0
2013	<b>941.9</b>	252.3	207.9	254.8
2014	<b>1,272.5</b>	265.3	150.5	507.5

**Sources:**

1. National Statistics Office of Georgia (Statistical survey of the "foreign economic activity»);
2. National bank of Georgia
3. Ministry of Economic and Sustainable Development of Georgia 2014;

In Table 5, we can see the stable development and growth of foreign direct investments in Georgia. The tendency has been held for last seven years. It is held by the stable economy, political situation, low labor cost and educated workforce. The author argues that the unstable political situation in 2009 (post-war period) has significantly lowered the inflow of foreign direct investments. This tendency has not held for a long time; the table 1 shows that the investments in 2010 were better by 20%, and the numbers are continuing to increase. We see a little decrease in foreign direct investments in 2012 as many scientists argue the political instability is one of the derivatives for foreign direct investments it became an actual example for Georgia. In October 2012, the parliamentary elections have been held, and the new political party got the majority in parliament. The fundamental changes made an unstable situation in the country, and it scared the investors. According to the dates of the national state office of Georgia, we can see a positive changes in 2014 the foreign direct investments have increased.

It could be crucial for Georgian economy if there are huge amounts of foreign direct investments, but it is essential to see to which economic sector foreign direct investments mostly go. In case if foreign direct investments are going into productive sectors the economy of the country will be affected positively. According to Wang (2009) study, it is preferable to invest in manufacturing industry rather than any other sectors. His study was made in Asian countries, for data he used 12 countries, and the studies have shown that in most cases it is more positive for a country to invest in manufacturing sector rather than in any other sectors. We can see the similar results in work made nearly 20 years ago by Jasinowski (1992). His work has shown that investments in the manufacturing sector can increase the country's economic growth. (Jasinowski (1992))

In Table 6 we can see the dates of the National Statistical Office of Georgia that top sectors for Georgia are transportation and communication, energy sector, building, and

manufacturing sector. As it is known for empirical evidence, the poor conditions of infrastructure are crucial for economic growth, when developed infrastructure works positively on economic growth of the country. Munnell (1992) after a couple of works he made decisions that investments into infrastructure give incentives to the economy, and it will have a positive effect economic growth. (Munnell 1992)

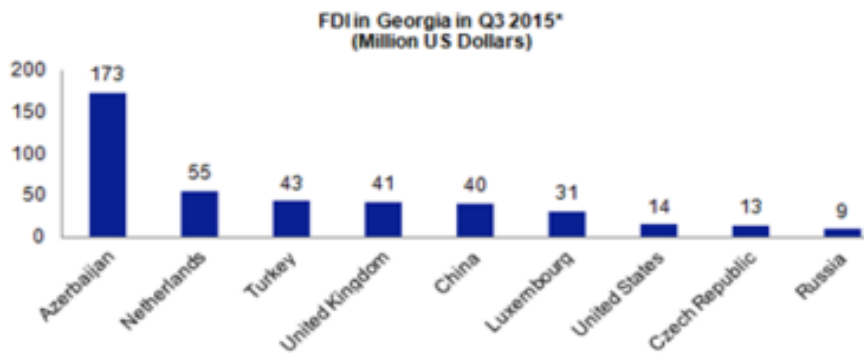
**Table 6** FDI in Georgia by Economic Sectors

FDI in Georgia by Economic Sectors								
Thousand of USD								
	2007	2008	2009	2010	2011	2012	2013	2014
<b>Totally</b>	2,014,841.6	1,563,962.4	658,400.6	814,496.6	1,117,244.1	911,564.3	941,902.6	1,272,452.0
Agriculture, Fishing	15,527.9	7,844.3	22,326.9	8,631.9	14,907.6	16,119.3	11,857.4	19,090.6
Mining industry	86,170.0	18,105.2	15,023.4	53,435.9	40,219.6	4,862.2	43,704.9	48,416.5
Manufacturing	312,070.9	188,287.8	124,781.7	175,334.5	120,339.7	167,906.5	99,765.1	174,046.0
Energy Sector	362,581.1	294,864.8	-2,130.6	21,877.9	203,951.6	179,402.6	244,745.1	98,740.2
Building sector	171,891.8	56,725.3	105,218.8	4,705.9	48,112.2	41,839.2	49,847.5	294,966.1
Hotels and Restaurants	242,075.9	181,939.2	37,542.3	17,121.8	22,705.6	17,652.3	-13,360.1	39,678.2
transportation an communication	416,694.7	422,690.0	98,432.0	215,116.2	126,517.2	72,828.9	140,104.4	343,438.2
Health care and social assistance	458.3	550.6	289.1	1,182.4	16,827.0	17,550.8	720.0	667.9
Real Estate	30,543.9	277,837.7	147,410.3	119,253.0	224,776.3	52,805.6	42,294.6	87,035.4
Financial Sector	157,723.1	10,891.7	49,663.4	107,406.4	167,701.8	162,552.2	166,386.3	78,056.9
Other Sectors	219,104.1	104,225.8	59,843.3	90,430.7	131,185.5	178,044.8	155,837.4	88,316.2

**Sources:**

1. National Statistics Office of Georgia (Statistical survey of the "foreign economic activity»);
2. National bank of Georgia;
3. Ministry of Economic and Sustainable Development of Georgia;

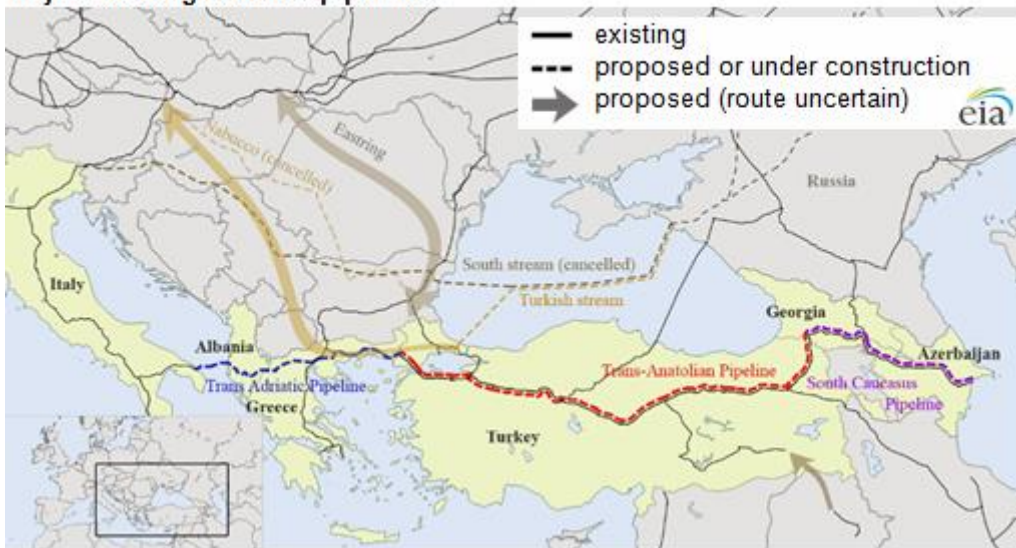
According to the data in Table 6 above, investments in Georgia tend to increase most of the time; however, since 2008 we observe a declining trend. The reason for this can be already mentioned political instability. Though, some other factors can also influence the flow of investments. Therefore, it is important to identify obstacles that prevent businesses from attracting more investments. Investment level in the economy is determined by the demand existing for investments or by the supply of financial resources. Consequently, it is crucial to discover why the investment level has decreased in the recent years and whether this reduction is temporary or not. (World Bank 2013) (F Schneider, B S. Frey 1985)



**Figure 1.** Foreign direct investment in Georgia by the country  
**Sources:** National Statistics Office of Georgia

In figure 1. Can be seen the top list of countries that have the biggest of investments in Georgia. At the top of the list is Azerbaijan, and it is not a surprise. The tensed political situation in the world makes Europe think about the alternative ways to get gas rather than from Russia. So big investments are made in the energetic sector. According to the U.S. Energy information Administration at figure 2. It can be seen the new natural gas pipeline under construction from Azerbaijan to southern Europe.

**Major natural gas transit pipelines**



**Figure 2.** Major natural gas transit pipeline.  
**Source:** U.S Energy information administration.



From the figure 2 above we can see that Georgia is one of the transit countries of natural gas between Europe and Azerbaijan that are the biggest reasons for big amount investments from Azerbaijan.

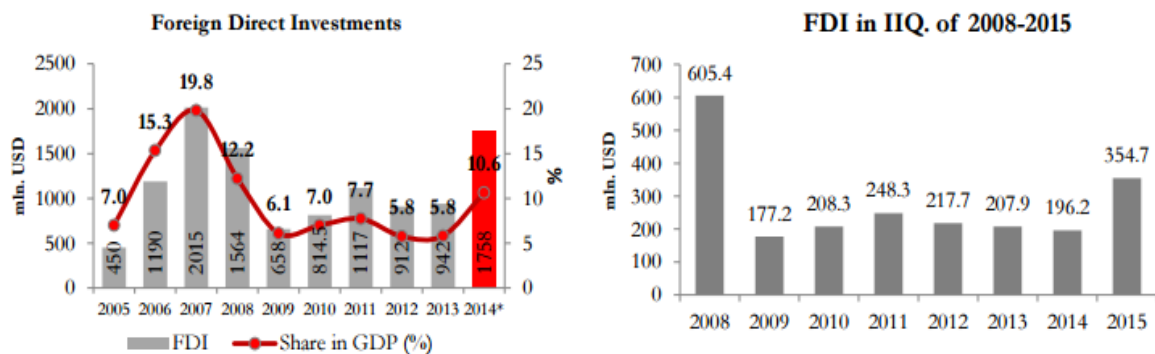
### 2.3. Foreign direct investment in Georgia by the second quarter of 2015

According to the ministry of economy and sustainable development of Georgia, one of biggest priorities is attracting foreign direct investments to the country. The liberal investment environment and equal approach to the local and foreign investors makes Georgia more attractive for investors.

Stable economic development, liberal and free-market economic policies, only 6 taxes and reduced tax rates, licenses and permits, administrative simplicity for preferential trade regimes with foreign countries, advantageous geographic location, well-developed and integrated transport infrastructure, an educated, skilled and competitive labor force and other factors represent a solid foundation for successful development of business in Georgia. From 2006 to 2014 foreign direct investments in Georgia was in a total equal to 10 972.2 million. USD.

The volume of foreign direct investments in Georgia in 2014 was 86.7% more than in 2013 and was equal to 1 758.4 million US dollars.

According to preliminary data in figure 3, the foreign direct investment in Georgia amounted to 354.7 US dollars million in 2015 II quarter, which is the highest rate since 2008, and 80.8% (by 158.5 million US dollars) more compared to the II quarter of 2014.



### Figure 3 FDI in Georgia

#### Figure 3a: FDI in IIQ

#### Sources:

1. National Statistics Office of Georgia (Statistical survey of the "foreign economic activity»);
2. National bank of Georgia;
3. Ministry of Economic and Sustainable Development of Georgia;

**Table 7** FDI in Georgia by Economic Sectors

FDI in Georgia by Economic Sectors								
Thousand of USD								
	2007	2008	2009	2010	2011	2012	2013	2014
<b>Totally</b>	2,014,841.6	1,563,962.4	658,400.6	814,496.6	1,117,244.1	911,564.3	941,902.6	1,272,452.0
Agriculture, Fishing	15,527.9	7,844.3	22,326.9	8,631.9	14,907.6	16,119.3	11,857.4	19,090.6
Mining industry	86,170.0	18,105.2	15,023.4	53,435.9	40,219.6	4,862.2	43,704.9	48,416.5
Manufacturing	312,070.9	188,287.8	124,781.7	175,334.5	120,339.7	167,906.5	99,765.1	174,046.0
Energy Sector	362,581.1	294,864.8	-2,130.6	21,877.9	203,951.6	179,402.6	244,745.1	98,740.2
Building sector	171,891.8	56,725.3	105,218.8	4,705.9	48,112.2	41,839.2	49,847.5	294,966.1
Hotels and Restaurants	242,075.9	181,939.2	37,542.3	17,121.8	22,705.6	17,652.3	-13,360.1	39,678.2
transportation an communication	416,694.7	422,690.0	98,432.0	215,116.2	126,517.2	72,828.9	140,104.4	343,438.2
Health care and social assistance	458.3	550.6	289.1	1,182.4	16,827.0	17,550.8	720.0	667.9
Real Estate	30,543.9	277,837.7	147,410.3	119,253.0	224,776.3	52,805.6	42,294.6	87,035.4
Financial Sector	157,723.1	10,891.7	49,663.4	107,406.4	167,701.8	162,552.2	166,386.3	78,056.9
Other Sectors	219,104.1	104,225.8	59,843.3	90,430.7	131,185.5	178,044.8	155,837.4	88,316.2

#### Sources:

1. National Statistics Office of Georgia (Statistical survey of the "foreign economic activity»);
2. National bank of Georgia;
3. Ministry of Economic and Sustainable Development of Georgia;

According to table 7 above foreign direct investment in Georgia by Economic Sectors. The biggest share of foreign direct investments holds transport and communication field, the amount invested in this sectors was 207.4 million US dollars (total investments of 58.5%), 41.4 million US dollars (total investment 11.7%) were invested into financial sector, in processing industry 29.5 million US dollars (8.3% of total investments) were invested, in construction sector - 24.7 million (7.0% of total investment), in real estate - 19.6 million (5.5% of total investment), and in hotels and restaurants - 18.2 million (5.1%).

According to the second quarter of 2015, the biggest foreign direct investment inflow was from Azerbaijan and the value was 160.2 million US dollars (45.2% of total investments), the second biggest investor country was Netherlands the total amount of 67.7 million US dollars

(19.1% of total investments) were invested into Georgia, the third place got Turkey with total amount of 41.0 million US dollars (11.5% of total investments). (The ministry of economy and sustainable development of Georgia)

**Table 8.** The foreign direct investment by the regions

Regions	2015		
	Q I	Q II	Q III
<b>Total</b>	<b>175,283.1</b>	<b>354,749.3</b>	<b>489,006.8</b>
of which:			
Tbilisi	87,241.4	274,923.8	432,543.3
Adjara	38,798.4	24,269.0	11,389.8
Kakheti	-6,544.3	2,015.9	-3,709.4
Samtskhe-Javakheti	19,262.5	12,829.2	10,187.6
Kvemo Kartli	23,513.8	4,876.8	16,123.6
Samegrelo-Zemo Svaneti and Guria	20,965.5	29,488.5	24,633.0
Imereti, Racha-Lechkhumi and Kvemo Svaneti	2,626.8	2,925.3	-7,129.3
Shida Kartli and Mtskheta-Mtianeti	-10,581.0	3,420.8	4,968.1

**Source:** National Statistics Office of Georgia

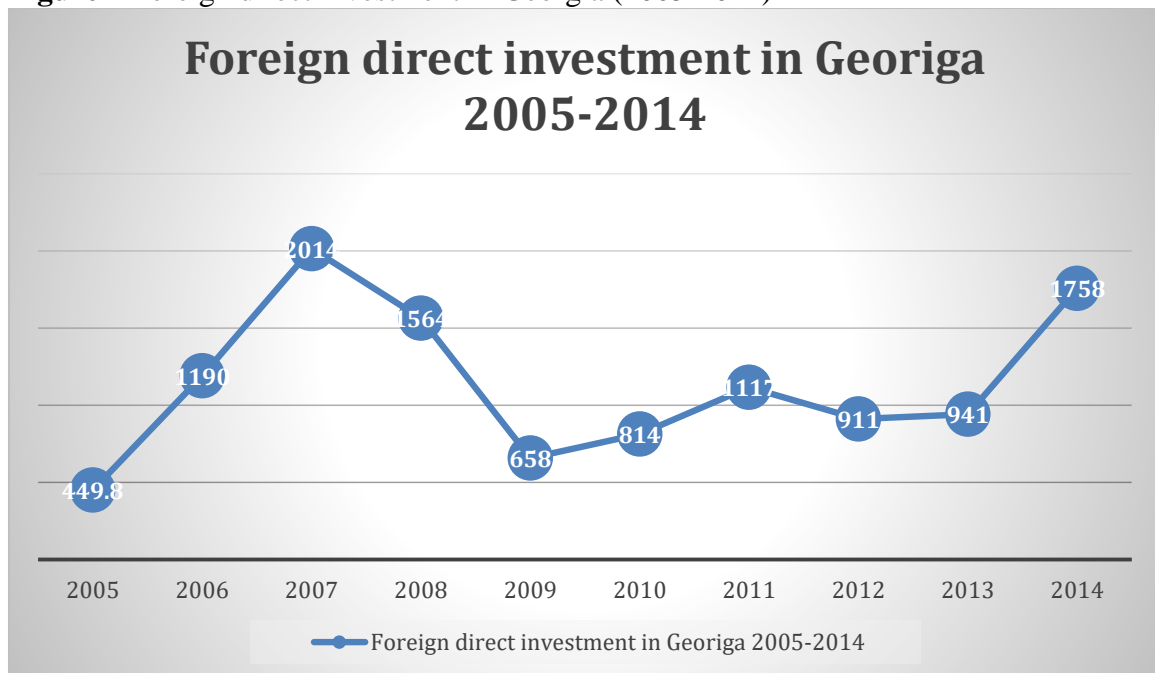
According to the data provided by the National Statistics Office of Georgia, it can be clearly seen in Table 8 the top regions of Georgia by investments. The tendency is negative; it can be seen that the biggest investments inflow is going to the capital of Georgia Tbilisi, and the other regions are not taken into account. According to the ministry of economy and sustainable economy, the government is investing into regions, but they can't attract the foreign investments at the moment. According to the Minister of Economy George Kvirikashvili (2015) Georgian government starts to work on developing the region of Georgia as well. They are going to start agricultural programs, and foreign investors with local investors will have benefits investing into this sector. (The Ministry of Economy and sustainable economy 2015)

## 2.4. The pros and cons of foreign direct investments in Georgia

Foreign direct investments in Georgia is an aspect of speculations. Since 2005 to 2014 the inflow of foreign direct investments has dramatically changed many times. The data

provided in the figure are foreign direct investments inflow in Georgia. It is obvious that political and economic stability has a big effect of foreign direct investment. The war 2008 the world financial crises 2009 has reflection on figure. The tendency has held from 2009 the investment are grooving, slowly but still going upwards.

**Figure 4** Foreign direct investment in Georgia (2005-2014)



**Source:** National Statistics Office of Georgia

According to National statistics office of Georgia the foreign direct investment are growing last years. The 2008 war as mentioned above has it reflection on the figure for last ten years this was the worst year in case of foreign direct investment.

According to Turkish economists Faruk Guersoy and Hueseyin Kalyonu (2012) they argue in their work that foreign direct investment and GDP growth are closely related. Their work is based on years 1997-2010. They display that foreign direct investment and GDP have connection in Georgina economy as well. (H. Kalyoncu/ F. Guersoy 2012)

The authors had highlighted couple of main connections between foreign direct investment and GDP:

- Foreign direct investment brings new technology and knowledge that can't be available with only trade of goods and services.
- Foreign direct investment motivates domestic companies to “wake-up” and develop in a healthy competition with foreign enterprises.
- The host countries often get intelligent workforce, while the companies trains their employees.

But is foreign direct investment always good? Let's consider a hypothetical example. A Russian investor buys the 60% shares of the company for 50 million laris. This operation will increase the rate of foreign direct investment in Georgia with 50 million. Then he lent \$ 20 million to the Georgian venture with 10% interest rate for 1 year. This operation will increase Georgia's foreign direct investment increased to 22 million (for the return of the debt of the total votes). Now let us assume that any company can afford to pay off your debt problems, leaving him to be fined double the interest rate up to 20%. This means that the company will have to pay 2 million. It is a fine indicator of the increase in foreign direct investment of 2 million, despite the fact that this operation does not stand behind any positive economic effects. So it is clear that direct investment is only according to the discussion can be misleading, because this increase may be due to the economic activity, which cannot be called useful or profitable. Let's expand the example. To consider a Georgian businessman, Discontented investor attitude towards the company and employees, the company bought back a 60% stake. This operation will reduce the rate of foreign investment of 50 million, despite the fact that it is neither the company nor harmful for the country was not.

Of course, all in an equally useful and not profitable. Moreover, there are investments that are dangerous for the country. For example, if it damages the environment or operated by the local workforce. Direct foreign investment does not include the investment of all values, and hence the nature of investment, which is the same record.

## CONCLUSIONS

The primary object of this thesis was to review the literature and empirical studies about foreign direct investment, analyze and understand the role of foreign investments for developing countries like Georgia. Classify the different determinants of foreign direct investments according to some works, study various policies adopted by different countries, and have some idea of what will be good advice for Georgia.

The primary determinants of foreign direct investment are economic determinants, the policy framework for foreign direct investment and business facilitation. Main economic determinants are market size, some factors of production, openness, the return of the investment, human capital and economic growth. Policy determinants for foreign direct investment are the legal framework of the country, political risks, and taxation policy. Business facilitation shows a will of the country to receive the foreign direct investment. How does country work for foreign investors what kind of after investment service do they offer. This all determinants have a negative as well as positive effect on different countries. It depends on whether the countries have natural resources or it is a market-seeking.

Because of Georgia is in the middle of Europe and Asia it should have a significant role in Caucasus region. They should stimulate the flows of foreign capital with different policy's at the same time increase their market size. Because of the role of developed infrastructure is important in attracting foreign investments government and municipalities should invest into it, this will stimulate more foreign capital. This will be a good promoter of foreign investments not only recourse oriented investments but market-seeking as well. Georgian government should decide what sectors are investments most important and work to improve those determinants that will in future increase the inflow of investments.

The biggest problem of Georgia stays the Occupied Territories and Russian army on Georgian territory. There is a lack of political and economic stability. The biggest problem is Russia and at the moment the same problem is actual to the whole world, as author mentioned above the unstable situation in Russia makes Europe sets a new pipeline through Georgia, on one hand it is superb for Georgia, because a lot of investments are received from Azerbaijan

for finishing this project but at the same time the relationship with Russia becomes worth. Georgia government should normalize the relationship with Russia; this will reduce the political risks and will stimulate new foreign direct investment into the country. As it is known the low political risk and stable macroeconomic environment increases return on capital. An educated workforce is one of the determinants of foreign direct investment so Georgia government should work on improvement of workers knowledge. It is right that Georgia is still in early stages of development and the job done after the independence is huge, but they still need to follow the new trends in terms to increase the foreign direct investments. The new visa liberalization law is taking Georgia closer to EU membership. All this is a right pass to the development, but still a lot of work is needed.

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